COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

NOTICE OF CONTINENTAL TELEPHONE COMPANY OF KENTUCKY OF AN ADJUSTMENT IN ITS RATES	) CASE NO. 9011

O R D E R

PROCEDURAL BACKGROUND

On April 16, 1984, Continental Telephone Company of Kentucky ("Continental") filed notice with the Commission proposing to increase its intrastate telephone rates for service rendered effective May 5, 1984. The proposed rates would increase Continental's local revenue by $641,524 annually, an increase of approximately 3.9 percent over normalized local service revenue.

On April 23, 1984, the Commission suspended the proposed rates until October 5, 1984, to conduct public hearings and investigate the reasonableness of the proposal. A hearing was held on August 21, 1984, in the Commission's offices at Frankfort, Kentucky, with the Consumer Protection Division of the Attorney General's Office ("AG") being the sole intervenor.

This Order addresses the Commission's findings and determinations on issues presented and disclosed in the hearings and investigation of Continental's revenue requirements and rate design. In this Order the Commission has determined that Continental does not require an increase in rates at this time.

COMPANY BACKGROUND

Continental is a wholly-owned subsidiary of Continental Telecom, Inc. ("Telecom") (formerly Continental Telephone Corporation). Continental operates in all or part of 20 counties in the Commonwealth of Kentucky, having its principal office in London, Kentucky. Continental serves approximately 57,043 customer access lines.

ANALYSIS AND DETERMINATIONS

TEST PERIOD

Continental proposed and the Commission has accepted the 12-month period ending February 29, 1984, as the test period in this matter.

VALUATION METHODS

Net Investment

Continental proposed a Kentucky intrastate net investment rate base of $57,717,288[1] at February 29, 1984. The Commission has accepted the proposed rate base with two exceptions. Continental proposed an adjustment to its depreciation expense to reflect end-of-period plant in service and the change in depreciation methodology previously allowed by the Commission in Case No. 8428, Notice of Continental Telephone Company of Kentucky of an Adjustment of its Intrastate Rates, but failed to make a corresponding adjustment to its reserve for depreciation. Since the proposed adjustment to depreciation expense is to reflect the level of expense that would have been incurred during the test

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1 Revised Oberdorfer Schedule 4, Item 1(b).

period had those rates been in effect, the Commission is of the opinion that it is appropriate to account for the effect that the proposed depreciation expense would have on the accumulated reserve for depreciation had the proposed expense been the actual level of depreciation expense incurred during the test period. Thus, the Commission has increased Continental's reserve for depreciation by $1,213,399[2] to reflect additional depreciation expense allowed herein.

Continental further proposed to reduce its test period telephone plant in service by $86,797[3] to include the effects that their proposed erosion adjustment would have on rate base. The Commission has rejected the proposed erosion of customer premises equipment adjustment, as discussed in further detail in another section of this Order. Therefore, the Commission has disallowed this corollary adjustment.

Therefore, the Commission has determined the appropriate Kentucky intrastate net investment rate base at April 30, 1983, to be $56,590,686, calculated as follows:

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2 $1,492,679 increase in depreciation expense as shown in Oberdorfer Schedule 3, Item 5, page 14 of 14 X .8129 total intrastate separation factor = $1,213,399.

3 Revised Oberdorfer Schedule 4, Item 1(b).

Telephone Plant in Service	$ 90,036,142
Plant Under Construction	1,613,355
Less: Depreciation Reserve	24,790,132
Net Telephone Plant	$ 66,859,365
Add: Materials and Supplies	281,409
Less: Deferred Income Taxes	10,405,860
Pre 1971 Investment Tax Credit	36,882
Plant Allocated To Direct Sales	107,346
Net Investment Rate Base	$ 56,590,686

Capital Structure

Continental proposed an adjusted end-of-test year capital structure of $63,942,327 which contained 54 percent long-term debt, 2.03 percent preferred stock, and 43.97 percent common equity.[4] The adjustment to the test-year end capital structure was to delete the unamortized debt expense of $73,053 from the total amount of long-term debt.[5] The Commission is of the opinion that the amount outstanding for long-term debt should be utilized in determining the capital structure and thus has added it back.

Based on the ratio of intrastate net investment to combined net investment of .8176[6] the Commission has determined that Continental's capital applicable to intrastate operations is $52,338,975. This amount has been increased by $4,601,898[7] to include the intrastate balance in Unamortized Investment Tax Credits - Revenue Act of 1971 ("JDIC"). JDIC has been allocated

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4 Oberdorfer Schedule 4, Item 2, page 1.

5 Ibid., page 2.

6 Intrastate rate base of $56,590,686 ÷ total company rate base of $69,215,827 = .8176.

7 Initial staff request, Item 11(L).

to each component of the capital structure on the basis of the ratio of each component to the capital structure excluding JDIC. The Commission is of the opinion that this treatment is entirely consistent with the requirement of the Internal Revenue Service ("IRS") that JDIC receive the same overall return allocated to common equity, debt, and preferred stock.

Furthermore, the Commission has reduced capital by the amount of intrastate plant allocated to the unregulated direct sales program of $107,346.[8] This reduction has been made in order to reflect only capital supporting utility operations and has been assigned to the capital components based on the accepted capital structure.

Therefore, the Commission has determined the intrastate capital devoted to utility operations to be $56,833,527 as follows:

	Combined	Intrastate	Structure[9]
Common Equity	$28,116,081	$24,961,715	43.92%
Preferred Stock	1,300,000	1,154,119	2.03%
Long-Term Debt	34,599,299	30,717,693	54.05%
Total	$64,015,380	$56,833,527	100.00%

REVENUES AND EXPENSES

For the 12 months ending February 29, 1984, Continental had total company net operating income of $6,634,693.[10] In order to reflect current operating conditions, Continental proposed several

8 Initial staff request, Item 16, Oberdorfer Schedule 2, Item 4.

9 Adjusted to reflect inclusion of unamortized debt expense.

10 Oberdorfer Schedule 3, Item 1.

adjustments to revenues and expenses including several adjustments presented at the August 21, 1984, hearing that resulted in an adjusted test period intrastate net operating income available for return of $5,591,797.[11] The Commission has determined the appropriate level of adjusted test period net operating income available for return from intrastate operations to be $6,562,563.

In its analysis of Continental's operations, the Commission has accepted the majority of the pro forma adjustments including the 1984 wage adjustment, with a reduction of 13 employees and normalized end-of-period local service revenues. In the following sections the Commission will outline the adjustments which it did not accept and other adjustments made to Continental's intrastate net operating income:

Customer Premises Equipment ("CPE") Erosion Adjustment

Continental proposed to decrease its normalized test period local service revenue by $630,385 to reflect the erosion of lease revenue from embedded CPE as a result of the deregulation of new CPE and consequent competition in the CPE market. The amount of the adjustment was based on a 15-month period ending March 31, 1984. The average percentage monthly reduction in revenue thus determined was projected forward to the mid-point of the first year that new rates would be applicable.[12]

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11 Oberdorfer Schedule 3, Item 1 and Revised Oberdorfer Schedule 4, Item 1.

12 Direct Testimony of William Oberdorfer, page 12.

Continental's witness, Mr. William Oberdorfer, Financial Analyst for the Contel Service Corporation, on cross examination, stated that Continental's billing analysis reflected actual test period revenue erosion due to a decline in the amount of embedded CPE in service and, also, that the entire CPE erosion adjustment is outside of the test period.[13]

The Commission will not accept Continental's proposed CPE erosion adjustment for several reasons. First, the CPE erosion adjustment is based on a simple linear projection of an historical trend. In the opinion of the Commission, this is an inadequate means of predicting CPE erosion. While the Commission recognizes the phenomenon, it does not believe that Continental's embedded CPE base will diminish to nothing, which is the logical conclusion to Continental's historical trending technique. Second, as is the case with Continental's billing analysis in this rate case, any CPE erosion that may occur in the future will be reflected in any billing analysis filed in any future rate case. At the same time, any cost savings resulting from CPE erosion that may occur in the future will be reflected in any revenue requirement and expense adjustments made in any future rate case. In the opinion of the Commission, CPE erosion is more appropriately addressed from rate case to rate case through the known and measurable information contained in a billing analysis and financial exhibits than through a debatable adjustment to revenue requirement in an

[13] Transcript of Evidence ("T.E."), August 21, 1984, page 68.

isolated rate case. Third, Continental is well aware that the Commission is currently addressing problems associated with the sale and detariffing of embedded CPE in Administrative Case No. 269, The Sale and Detariffing of Embedded Customer Premises Equipment. Embedded CPE must be detariffed no later than December 31, 1987, by Order of the Federal Communications Commission in CC Docket No. 81-893, Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry). It is only subsequent to detariffing and the transfer of assets, revenues, and expenses to unregulated accounts that the impact of embedded CPE erosion can be fully appraised. Fourth, the Commission has not allowed similar erosion adjustments in past Continental rate cases, since such adjustments are inherently debatable and can be offset by changes in productivity and management efficiency. In the opinion of the Commission, to allow the embedded CPE erosion adjustment would remove any incentive for Continental to improve the productivity and efficiency of its operations, as a business in a competitive market would be required to do if confronted with a similar situation. Finally, in this Order the Commission has used Continental's end of period rate base and allowed Continental certain known and measureable expense adjustments which extend beyond the end of the test period. In the opinion of the Commission, these actions will mitigate the effect of embedded CPE erosion on Continental's ability to earn the rate of return found reasonable in this Order.

The Commission has therefore increased Continental's net intrastate operating income available for return by $319,983.

Toll Service Revenue

In its application, Continental proposed to increase its toll service revenues for message and wide area telecommunications services by $1,589,822 to an adjusted intrastate toll service revenue level of $8,268,574[14] exclusive of private line toll revenue which will be addressed in another portion of this Order. At the hearing on August 21, 1984, using recomputed access minutes of use Continental proposed to reduce its pro forma toll service revenue, exclusive of private line toll, by $549,758[15] to $7,718,816.

Mr. Oberdorfer, in prefiled testimony, stated that the toll service revenue adjustment was "based on current approved tariff rates applied to actual usage during the 12 months ended December 31, 1983, the most recent usage information available."[16] There was no indication in Mr. Oberdorfer's prefiled testimony of any adjustment to Continental's 1983 toll usage data. However, at hearing, on cross examination, Mr. Oberdorfer indicated that Continental's 1983 toll usage data had been adjusted downward based on a Subscriber Line Usage ("SLU") to access minutes of use ratio of 95 percent, which had been developed "based on discussions that the company has had with its network personnel

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14 See Oberdorfer Schedule 3, Item 5, and Public Service Commission Supplemental Data Request dated June 27, 1984, Item 5.

15 See Revised Oberdorfer Schedule 4, Item 1(a).

16 Direct Testimony of William Oberdorfer, p. 16.

and, as I understand it, on other telephone company experience."[17] Mr. Oberdorfer's statement was reiterated in Continental's response to a staff request for information made at hearing.[18]

Also, at the hearing, on direct examination, Mr. Oberdorfer proposed that the SLU ratio be revised to 84.2 percent, based on "the company's actual experience in the first quarter of 1984."[19] This revised SLU ratio also is the origin of Continental's proposed reduction in its initially filed toll service revenue adjustment.

Although the Commission acknowledges that some adjustment to Continental's 1983 toll usage data may be appropriate, the Commission is also of the opinion that Continental has not met its burden of proof relative to any adjustment to its 1983 toll usage data and, furthermore, that Continental's 1983 toll usage data is itself questionable, for example, in its unexplained estimation of terminating minutes of use.

Continental has stated that its initially filed 95 percent SLU ratio was not based on any study: "No specific studies were performed by the Company."[20] Moreover, to the extent

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17 T.E., p. 31.

18 See Hearing Data Requests, Item 2. "The 95% ratio used in the original toll revenue adjustment is based on the experience of other telephone companies and discussions with Contel Network Service personnel. No specific studies were performed by the Company."

19 T.E., p. 31.

20 Hearing Data Requests, Item 2.

that Continental's use of a 95 percent SLU ratio was based on unsubstantiated "discussions with network personnel", the resulting adjustment to toll service revenue is, at best, debatable. To the extent that it was based on the "experience of other telephone companies", the adjustment may or may not be reasonable. In any case, Continental failed to provide any evidence concerning the experience of other telephone companies that the Commission could use as the basis for a judgment of reasonableness.

Likewise, if Continental's revised 84.2 percent SLU ratio was based on "actual first quarter 1984 experience", then Continental necessarily conducted some form of traffic analysis. However, no information concerning any such traffic analysis was filed by Continental, despite a specific request that supporting workpapers or studies be filed.[21]

Considering the lack of evidence to support an adjustment to Continental's 1983 toll usage data, the Commission will not allow any such adjustment.[22] Further, using Continental's

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21 See T.E., pages 31-32. The Commission notes that Continental did file a one-page summary workpaper without any explanation of the calculations shown and adjustments made. See Hearing Data Request, Item 2.

22 Since the Commission acknowledges that some adjustment to Continental's 1983 toll usage data may be appropriate, the Commission will advise Continental that if upon its review of this Order it believes that it can make sufficient evidentiary showing to support an adjustment to its 1983 toll usage data, then the Commission will entertain such evidence upon the filing of a petition for rehearing on this issue.

unadjusted 1983 toll usage data, the Commission has determined Continental's adjusted level of toll service revenue, exclusive of private line toll, to be $8,656,434.[23] This adjustment increases Continental's pro forma intrastate net operating income available for return by $475,935.

Private Line Revenue

Continental and South Central Bell Telephone Company ("SCB") use the cost method for determining Continental's share of private line revenues generated by the Kentucky intrastate toll network. Thus, Continental receives from SCB its actual intrastate toll operating expenses plus a return and matching taxes on its Kentucky intrastate toll rate base. The return paid Continental by SCB is SCB's achieved overall return from its intrastate operations. In this proceeding Continental has determined the return for the test period to be 10.97 percent.

In Case No. 8861, Notice of Continental Telephone of Kentucky of an Adjustment in its Rates, the AG proposed to increase Continental's private line revenues to reflect the anticipated private line tariff increases to be granted SCB in Case No. 8847, Notice of South Central Bell Telephone Company of an Adjustment in its Intrastate Rates and Charges. In this

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23 This represents the best estimate that the Commission can make using available information. It includes carrier common line and traffic sensitive revenues recomputed on the basis of Continental's unadjusted 1983 toll usage data, allocated between interlata and intralata usage in the same ratios as exhibited by Continental in Oberdorfer Schedule 3, Item 5. Billing and collections, non-access, and private line revenues were not recomputed.

proceeding the AG has again made a similar request. In its Order in Case No. 8861, the Commission stated:

> The adjustment alluded to by the AG is dependent upon the Commission's actions in SCB's current rate proceeding, Case No. 8847, which at this time has not been decided.[24]

Since then, the Commission has decided Case No. 8847 and has authorized SCB a 25 percent increase in its private line revenue. During the hearing Continental, while admitting that it mirrors SCB's private line tariffs, presented no direct evidence as to why the revenue adjustment proposed by the AG should not be made. Continental, while insisting that the adjustment would be improper, merely indicated that a cost-based settlement process takes place in determining the toll-related private line revenue to be realized.[25] The Commission is of the opinion that a 25 percent increase in SCB's private line rates, with the corresponding increase in Continental's rates, will yield an increase in Continental's revenues. Absent evidence showing the exact amount of revenue Continental can expect under the settlement process, the Commission is of the opinion that the entire 25 percent increase should be reflected in Continental's pro forma private line toll revenues.[26]

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24 Commission's Order in Case No. 8861, dated January 4, 1984, page 15.

25 T.E., pages 46-48.

26 The Commission advises Continental that if upon its review of this Order it believes it can make a sufficient evidentiary showing to refute this adjustment, then the Commission will entertain such evidence upon the filing of a petition for rehearing on this issue.

The Commission has determined this revenue to be $541,445,[27] an increase of $102,336 over Continental's adjusted level of $439,109. This results in an increase to Continental's pro forma intrastate net operating income available for return of $51,946.

Employee Concession Service

During the test period Continental granted its employees concessions amounting to $33,948, consisting of reduced rates for local telephone service. The Commission is of the opinion that the ratepayer should not be required to pay the cost of employee concession service as no tangible benefits accrue to the ratepayers. Therefore, the Commission has increased Continental's local service revenues by this amount.

This adjustment is in accordance with recent Commission decisions on this issue (e.g., Case No. 8467, Notice of South Central Bell Telephone Company of an Adjustment in its Intrastate Rates and Charges) and has the effect of increasing Continental's intrastate net operating income available for return by $17,232.

Uncollectible Revenue

Continental had actual test period uncollectible local service revenue of $108,314 which it increased on a pro forma basis to $120,833. The Commission, using Continental's net write-off of .2923 percent and incorporating the Commission's

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27 Adjusted private line toll revenue of $433,156 X 1.25 = $541,445.

adjustments to local service revenue, has increased Continental's pro forma uncollectible revenue by $1,942.

The Commission has therefore reduced Continental's net intrastate operating income available for return by $986.

Centralized Message Distribution System ("CMDS")

Continental proposed a revised intrastate pro forma CMDS expense of $63,405. This expense reflects the amount to be billed to Continental for message volume data provided by CMDS for use in toll traffic studies. In the past the cost of this service was included in the settlements and separations process; however, because of the divestiture of the local Bell operating companies from AT&T, beginning in January 1, 1984, Continental will be billed directly for this expense.

Based on the actual message volumes applicable to CMDS of 2,741,260[28] for the test year and the current rate of $.02[29] per message the Commission has determined that the appropriate level of CMDS expense to be included for rate-making purposes on an intrastate basis is $44,173, a reduction of $19,232.

Therefore, the Commission has increased Continental's net operating income available for return by $9,762.

Revenue Accounting Expense

Continental proposed to reduce its test period revenue accounting expense by $46,723 on an intrastate basis. This

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28 August 21, 1984, hearing data requests, Item 9.

29 Initial staff request, Item 16, Oberdorfer Schedule 3, Item 13.

adjustment was made to remove a non-recurring expense for the development and implementation of access charge billing and recording systems and to reflect an average on-going level of expense for the month in which the development and implementation charges were incurred. In arriving at its adjustment, Continental used a 12-month average which included the amounts which were to be adjusted. The Commission is of the opinion that this distorts the outcome and that a more reasonable approach is an 11-month average which excludes the unusual amounts in question. The Commission has determined this 11-month average to be $46,375 on an intrastate basis, $4,248 less than Continental's 12-month average of $50,623. Therefore the Commission has reduced Continental's pro forma revenue accounting expense by this amount.

This adjustment increases Continental's intrastate net operating income available for return by $2,156.

Carrier Access Billing System Expense

Continental proposed to reduce its intrastate expense for general services and licenses by $48,885 in order to account for non-recurring carrier access billing system ("CABS") development expenses incurred during the test period.[30] The intrastate amount of this expense incurred during the test period was $76,725. Mr. Oberdorfer testified that it was his intention to remove the entire cost of this expense when he stated ". . .by means of the revision that I've submitted today, I'm removing that expense from

30 Revised Oberdorfer Schedule 4, Item 1(d).

the ratepayers, and it's basically being borne by the shareholder."[31] Continental does anticipate that there will be recurring expenses associated with CABS but was unable to quantify it and thus included an arbitrary amount by using a test period 12-month average of general services and licenses in determining the amount of expense reduction to the account.[32] The Commission is of the opinion that the amount of CABS expense thus included in general services and licenses fails to meet the known and measurable criteria requirements for being included for rate-making purposes. Therefore, the Commission has reduced general services and licenses on an intrastate basis by an additional $27,840.

This adjustment increases Continental's intrastate net operating income by $14,132.

Operating Rents

Continental proposed to reduce its operating rents expense by $43,093 on an intrastate basis in order to eliminate a non-recurring expense included in the test period operations and to reflect a normal on-going level of expense. In determining the monthly average Continental included the month which contained the unusually large non-recurring expense. The Commission is of the opinion that this methodology distorts the average thus obtained and that a more appropriate methodology is an 11-month average

31 T.E., page 42.

32 T.E., page 42.

which excludes the unusual month in question. The Commission has determined this 11-month average to be $18,413 on an intrastate basis, $3,918 less than Continental's 12-month average of $22,331. Therefore, the Commission has reduced Continental's operating rents expense by this amount.

This adjustment increases Continental's intrastate net operating income available for return by $1,989.

Depreciation Expense

Continental proposed to increase its test period intrastate depreciation and amortization expense of $5,250,862 by $1,222,944 to a pro forma level of $6,473,806 in order to reflect the Remaining Life depreciation rates allowed by the Commission in Case No. 8861 and the incremental difference between the Equal Life Group rates and Remaining Life rates to the additions made to the Equal Life Group accounts approved during the test period. Continental further revised this adjusted level to include a $45,639 reduction to reflect the effects on this expense of the proposed reduction to plant in service associated with the CPE erosion adjustment discussed above. Since the Commission has rejected the proposed erosion adjustment, it will also disallow this corollary adjustment to depreciation.

This adjustment has the effect of reducing Continental's net operating income available for return by $23,166.

Property Taxes

Continental increased its intrastate property tax expense by $74,477 from $554,961 to $629,438. The Commission, based on its adjustments to Continental's plant in service and depreciation reserve and using Continental's methodology, has reduced intrastate pro forma property taxes by $11,159 to $618,279.

This adjustment increases Continental's intrastate net operating income available for return by $5,664.

Interest Synchronization

Continental proposed intrastate interest expense for rate-making purposes of $2,503,005. The Commission continues to be of the opinion that its past treatment of JDIC is proper and consistent with IRS regulations and such treatment will continue in this proceeding. In accordance with past practice, the Commission has applied the cost rates applicable to long-term debt to the JDIC allocated to the debt components of the capital structure. Using the capital structure allowed herein, the Commission has computed a net interest increase of $89,568 which results in an increase in Continental's intrastate net operating income available for return of $44,103.

However, as this issue is currently on review to the Kentucky Supreme Court, the Commission finds it reasonable to adopt the position taken in Case No. 8861. In that proceeding the Commission stated that if a final decision should be adverse to the Commission's position, it would consider a rate adjustment to generate the revenues associated with JDIC. This should eliminate the need for judicial appeal of the matter.

Affiliated Transactions

In its previous Order in Case No. 8861, the Commission instructed Continental to perform studies which indicate whether or not Continental's ratepayers are enjoying any benefits from Continental's relationship with its affiliated companies and reminded Continental that the burden of proof of the reasonableness of the expense rests with them.[33] In this proceeding Continental provided a report which consisted of a ratio analysis comparing Continental with other Kentucky telephone companies owned by holding companies and other independent telephone companies of comparable size; historical analysis of expenses; historical analysis of affiliated interest fees, including adjustments for inflation; and pro forma analysis of revenues and expenses. In this report Continental did not perform a total productivity study or a cost analysis to determine the level of expense that would be incurred should Continental contract for these services on an individual basis. Instead Continental relied primarily on comparisons with other telephone companies to prove its cost effectiveness. The Commission finds these comparisons to be unconvincing.

Further, Continental dealt almost exclusively with its total operations. The Commission in Case No. 8861 stated that

> The Commission agrees that an evaluation of Continental's organizational structure should include an examination of the total operations of Continental; it should also include an examination of the various components which make up that whole. An organization may be cost effective overall and still include components that of themselves are not cost effective. The possibility of Continental's

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33 Commission's Order in Case No. 8861, dated January 4, 1984, page 12.

ratepayers providing revenues in excess of those otherwise required to pay for these services is of great concern to this Commission.[34]

Only the historical analysis of affiliated interest fees dealt with any specific component that makes up Continental's total operation.

In this section of the study Continental stated that it "concurs with the Commission on the validity of comparing management service charges to CPI increases." However the "compounded rate of growth is a more relevant measure of the issue at hand."[35] The Commission is of the opinion that in general a compound growth rate is a more widely accepted measure of growth and will in this instance accept Continental's determination of a compound growth rate in the consumer price index ("CPI") of 9.49 percent. However, since Continental failed to provide convincing evidence of the reasonableness of its affiliated charges the Commission will continue to hold these expenses to the CPI growth rate.

Continental's pro forma total company affiliated charges for management service as adjusted herein is approximately $1,637,753.[36] The Commission has determined the level of this

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34 Ibid., page 11.

35 Exhibits in support of an increase in rates, witness 3, Contel charges, page 1.

36 Executive department of $153,005 + revenue accounting of $745,530 + general services and licenses of $733,218 = $1,631,753.

expense adjusted to reflect a compound growth rate of 9.49 percent is $1,507,955 and has reduced affiliated charges on a total company basis by $129,798.

This adjustment increases Continental's intrastate net operating income available for return by $52,016.[37]

Summary of Adjusted Net Operating Income

The Commission, based on the foregoing analysis, has determined Continental's appropriate intrastate adjusted test period net operating income available for return to be $6,562,563 as set out below.

	Proposed	Adjustments	Reasonable
Operating Revenues	$25,373,498	$ 1,702,345	$27,075,843
Operating Expenses	19,781,701	731,579	20,513,280
Net Operating Income Available for Return	$ 5,591,797	$ 970,766	$ 6,562,563

RATE OF RETURN

Cost of Capital

Continental proposed a debt cost of 8.73 percent on a pro forma 1984 financing basis. This percentage includes $3 million of additional debt that was to have been issued in 1984.[38] Per testimony of Mr. Oberdorfer, this amount of additional debt had not been issued as of the hearing date.[39] In light of the uncertain nature of these financings and the fact that no

37 ($129,798 X weighted average separation factor of .7895) X (1 - .4924) = $52,016.

38 Prefiled Testimony of William Oberdorfer, page 40.

39 T.E., page 53.

application for the approval of additional financing has been submitted before the Commission at this date, the Commission is of the opinion that the pro forma debt cost should be rejected. Therefore, the embedded cost of 8.44 percent, based on the outstanding amount of long-term debt at the end of the test year, is reflective of Continental's actual costs.

Continental proposed a 9.27 percent cost rate based on the outstanding preferred stock at February 29, 1984.[40] The Commission is of the opinion that this rate is reasonable for preferred stock.

Mr. Oberdorfer recommended a 14.25 percent return on equity based on the Commission's January, 1984, decision in Case No. 8861.[41] No intervenors offered objections or alternatives to this proposal.

After considering all of the evidence, including the current economic conditions, the Commission is of the opinion that a return on equity of 14.25 percent is fair, just and reasonable. This return on equity would not only allow Continental to attract capital at reasonable costs to insure continued service and provide for necessary expansion to meet future requirements, but also would result in the lowest reasonable cost to the ratepayer.

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40 Prefiled Testimony of William Oberdorfer, page 40.

41 Ibid.

Rate of Return Summary

Applying rates of 8.44 percent for long-term debt, 9.27 percent for preferred stock and 14.25 percent for common equity to the capital structure approved herein produces an overall cost of capital of 11.02 percent. The additional revenue granted herein will provide a rate of return on net investment of 11.07 percent. The Commission finds this overall cost of capital to be fair, just and reasonable.

REVENUE NEEDS

The additional revenue required based on the rate of return found fair herein is computed as follows:

Required Net Operating Income	$ 6,263,055
Adjusted Net Operating Income	6,562,563
Sufficiency	$ 299,508
Sufficiency Adjusted for Taxes and Uncollectibles (.5062)	$ 591,679

CONSTRUCTION ACTIVITIES

Continental has undertaken a large construction program of modernizing its central offices throughout the state. Electro-mechanical central office equipment has been replaced with digital electronic switching equipment in many exchanges. The largest of these projects is the London digital island where many exchanges will be upgraded to digital switching along with fiber optics outside plant.

This construction should provide for better, more reliable telecommunications services to the subscribers in the London area. Many customers should be able to obtain single party service where it is not available presently once this construction is performed. From a service standpoint this construction will be extremely helpful; however the Commission is concerned with the cost of this modernization.

Where facilities presently exist and provide adequate service a company must prove that modernization is the most economical plan of action if the company intends to proceed in that direction. To do this the company usually performs discounted cash flow studies over a suitable period which compares the cost associated with retaining the existing equipment and replacing it with more modern equipment. When the cash flow studies indicate that the replacement plan is more economical, there will be an associated discounted payback period. This is the time interval starting from the beginning of the study to the point at which the cumulative discounted cash flows become equal. After this point the cumulative cash flows will be greater for the retention of existing equipment plan. Before this point the cumulative cash flows will be greater for the replacement plan. The discounted payback period reflects the higher up-front capital cost of the new equipment compared to the long-run increased maintenance and other costs associated with the old equipment.

The Commission is very concerned with the fact that Continental did not perform a study which considered retaining the existing facilities in the London area. Without this study, there can be no comparison of the cost of replacement and retention of facilities. There also is no discounted payback period which reflects the period which the new equipment would have to remain in place to actually be more economical than the existing equipment. The Commission has asked Continental to perform such a study which Continental agreed to; however that study has not been filed. The Commission is also concerned with the validity of a study performed after the fact; however it has no evidence to question it at this time. In any event, if the study shows the London plan to be more costly than retention of existing facilities the Commission may consider the matter in a later proceeding.

FINDINGS AND ORDERS

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that:

1. The rates proposed by Continental would produce revenues in excess of those found reasonable herein and should be denied upon application of KRS 278.030.

2. The rates and charges presently in effect should remain the fair, just and reasonable rates and charges for Continental to charge its customers for telephone service.

IT IS THEREFORE ORDERED that the proposed rates and charges in Continental's notice of April 16, 1984, be and they hereby are denied.

IT IS FURTHER ORDERED that the rates and charges presently in effect shall continue to be the rates and charges authorized for all service rendered on and after October 5, 1984.

Done at Frankfort, Kentucky, this 5th day of October, 1984.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary